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UPDATE:

Hedging Breakdown Drives Investors To Managed Futures Funds

(Updates with comment by Hennessee Group.)

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Hedge funds' failure to successfully hedge during the financial crisis has investors looking for alternatives, and that has been driving them to managed futures funds in search of investments that are not correlated to the rest of the market.

Many common strategies for hedging investments have broken down, as correlation between equities and other asset classes is high. Different asset classes have behaved similarly, making a mess of efforts to hedge against losses. Hedge funds on average lost 19% in 2008.

"High correlations are here to stay in the foreseeable future as the world becomes more interconnected and it is harder for companies to have sustainable competitive advantages," said Sebastian Ceria, founder and chief executive of Axioma Inc., which makes portfolio-construction and risk-management tools.

Individual stocks are more often trading in lockstep with one another, throwing a wrench in hedging, which seeks assets that perform differently. Average pairwise correlation among individual stocks in the Russell 1000 index is now 0.5, retracing from an all-time high of 0.61 between April and July, but still up from the post-crisis low of 0.31, according to Axioma. A correlation of 1.0 would mean two stocks move completely in sync.

The increased correlation makes it hard for fund managers to generate alpha, or beat the market, particularly for fundamentally based long, short equity hedge funds.

"The 'risk on-risk off' trade, driven largely by macro sentiment, continues to dominate the financial markets," Hennessee Group LLC's co-founder Charles Gradante said. "Until we see fundamentals return to the forefront of investing, we believe hedge funds will have difficulty executing their investment strategy, particularly on the short side." Hennessee Group is a consultant and adviser to direct investors in hedge funds.

Fund managers point to several culprits for the high correlation. The popularity of exchange-traded funds, in which collections of stocks trade as a package on an exchange, is a force driving the equities underlying the ETF to be traded in lockstep. The Federal Reserve's program of quantitative easing and the troubles of European sovereign states have, some managers say, upset the normal market order, and led investors to move herdlike in and out of asset classes, seeking to dodge shifting currencies. Some managers also point to high-frequency trading for accentuating sharp risk-on, risk-off market swings.

Investment advisers say despite a rebound in confidence and readiness to deploy new capital, investors are spending more time studying risks, in the hope of finding a real hedge.

The heightened risk awareness is reflected in the increased allocations to the managed futures strategy, where Commodity Trading Advisors, or CTAs, actively manage client assets using global futures markets. CTAs trade in more than 150 markets worldwide, including stock indexes, financial instruments, agricultural products, precious and nonferrous metals, currencies and energy products.

Those futures are market neutral or have negative correlations to the traditional stock and bond markets. Portfolios can be diversified by geography as well as by product.

"During the financial crisis, liquidity was an issue for many hedge fund managers who traded underlying assets that aren't as liquid and some had to put up gates for redemptions. But that wasn't a problem for managed futures managers as the futures market had a great deal of liquidity," said Tim Wong, the chief executive of Man Investment's managed futures manager, Man AHL. Active trading in futures, he said, actually reduces market correlations.

Man AHL manages \$23 billion assets and had a 33.2% net return in 2008 for its flagship Man AHL Diversified fund amid the choppiest market conditions. The investment manager, which invests in global futures, reported a compound annual return of 20.1% from its inception in 1997 through 2008, equating to a total return of 935.5% since inception, compared with just 28.4% for world stocks over the same period, at a similar level of risk.

Managed futures funds accounted for about 12.5%, or \$223.4 billion of the total \$1.78 trillion invested in all types of hedge fund strategies at the end of the second quarter, surpassing event-driven and emerging-markets strategies to be the largest category, data provider BarclayHedge Ltd. said.

"This last year there has finally been a true appreciation for non-correlated return funds," said Patrick Welton, chief executive of Welton Investment Corp., an alternative investment manager specializing in managed futures and global macro strategies.

The Barclay CTA Index--which measures managed futures performance--held up during the downturn. In 2008, the index rose 15%, against a 37% fall in the S&P 500. Year to date through October, the CTA index rose 4.53%, against the S&P's gain of 7.84%.

"With interest rates near zero and equities' yield flat for the past 10 years, it is essential to have a portion of one's assets in alternative investments that have no correlation with the rest of the portfolio," said Bob Gelfond, chairman and chief executive of quantitatively oriented global macro hedge fund MQS Asset Management.

Gelfond, a former Millennium Partners LP managing director and D.E. Shaw & Co. director of international trading, said MQS uses quantitative models and active management for its portfolio, seeking uncorrelated trades across interest rates, currencies, fixed income and equities.

Another sign of the heightened interest in hedging: Axioma has seen its portfolio-construction and risk-management tool business grow 50% for the second consecutive year.

When correlations are high and it is tough to beat the market, "only the skilled money managers survive," Axioma's Ceria said.

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